

1962

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Recommended Citation

James W. Quiggle and John Holt Myers, *Tax Planning the Administration of an Estate*, 30 Fordham L. Rev. 651 (1962).

Available at: <https://ir.lawnet.fordham.edu/flr/vol30/iss4/2>

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Cover Page Footnote

Members of the District of Columbia and Maryland Bars. The authors wish to thank Mildred E. Foy, Trust Officer of the Riggs National Bank of Washington, D.C., for her helpful comments and advice in the preparation of this article.

TAX PLANNING THE ADMINISTRATION OF AN ESTATE

JAMES W. QUIGGLE*

JOHN HOLT MYERS*

I. INTRODUCTION

SINCE the onset of the federal estate tax,¹ much time and effort has gone into the planning of the estates of those fortunate enough to come within its purview. Professionals of widely diverse backgrounds, whether their function be to create the estate or to manage it as professional executors or as attorneys acting as counselors both before and during the administration, have found it necessary to familiarize themselves with all facets of the tax. Despite the marital deduction² and the \$60,000 exemption,³ these efforts are justified since once an estate is taxable, the rate of tax is rapidly progressive.⁴

Interestingly enough, little attention seems to have been devoted to the federal tax problems involved in the administration of the estate. The purpose of this article is to suggest that there are important alternatives facing the executor, both before and during the administration of the estate, which affect not only the income tax payable by the estate or its beneficiaries but the estate tax as well.

Decisions are often made by executors and administrators without consideration of the tax consequences. There are a number of reasons why this is so, but two immediately come to mind. First, the early period of the administration of an estate is usually a period of emotional dislocation. Those who should participate in the making of the decisions, because they are the ones who ultimately will be affected (the beneficiaries and legatees), are often in no mood to consider the alternative courses available. The second cause may be found in the nature of the fiduciary. Executors and administrators appear to fall into two classes, with no middle group. They are either highly experienced and hence, necessarily somewhat impersonal professionals, or on the other hand, completely inexperienced members of the family. The counselor as an intermediary can serve a very useful function by analyzing the estate from the stand-

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1. Int. Rev. Code of 1954, § 2001.

2. Int. Rev. Code of 1954, § 2056.

3. Int. Rev. Code of 1954, § 2052.

4. E.g., an estate in excess of \$50,000 is taxable at 25 per cent, and one in excess of \$100,000 at 30 per cent. Int. Rev. Code of 1954, § 2001.

point of the income and estate tax decisions to be made.

Primary attention will be devoted herein to federal *income* tax planning for the reason that most of the federal estate tax decisions will have already been made because the estate exists in a form which cannot be changed by the executor. We will, however, also make note of those choices facing an executor which may have a direct bearing upon the federal estate tax. Consideration will also be given to the interaction of available alternatives on both taxes. A decision may affect not only the federal estate tax but also the income tax payable either by the estate or by the beneficiary receiving the income. A simple example should serve to illustrate this point. The election of an optional date for valuation purposes may well reduce the federal estate tax. On the other hand, in the event of sale of the property, the reduction in value reduces the basis which is carried over to the legatee or beneficiary. In case of subsequent sale the gain and tax thereon will be correspondingly increased. Only computation will tell whether the election is really of benefit.

One final word of caution. No longer is it possible to ignore completely the state tax consequences and make decisions purely on the basis of federal law. Although most of the choices discussed below will ordinarily not give rise to state inheritance and income tax problems, there lurks in each the possibility of an unconsidered detriment. As state taxes continue to rise the danger increases correspondingly. By way of example, the election of a fiscal year for federal income tax purposes should be supported by the election of the same year for accounting purposes as well as for state or local income tax purposes.

II. PRE-DEATH DECISIONS

Before discussing income and estate tax aspects of the administration of an estate, it might be wise to restate an axiom well known to tax practitioners; namely, that decisions made prior to death can have a substantial effect on the federal taxes due after death.

A. *Estate Tax*

No purpose would be served by reviewing the multi-faceted problem of planning the estate for federal estate tax purposes. Suffice to say, there may be late decisions which the counselor or prospective executor can recommend which will be of benefit in the administration of the estate. For example, if death seems imminent, consideration should be given to investment in federal estate tax payment bonds. Such bonds, designated by the Treasury as acceptable at par for the payment of federal estate taxes,⁵ are often available at considerably less than their

5. Int. Rev. Code of 1954, § 6312.

maturity value. Should death occur within a reasonably short period after purchase of the bonds, there is built-in profit available when the federal estate tax is paid fifteen months after the date of death. There seems little reason for the Government to suggest that the purchase of such bonds in anticipation of possible death will disqualify their use. In simple fact, Uncle Sam has invited his subjects to take this gamble.

It should be noted that there is no longer support for the proposition that such bonds can be included in the estate at their fair market value rather than at the maturity value receivable on payment of the estate tax.⁶ Despite withdrawal of the opportunity to value at fair market and to receive par at maturity (the estate paying a capital gains tax on the difference at the time of satisfaction of the federal estate tax), use of these bonds may be of substantial benefit. This ordinarily will be the difference between the purchase price and maturity value reduced by the federal estate tax on the difference.

B. *Income Tax*

Just as a prospective decedent takes into consideration the federal estate tax consequences of ordering his estate before death, he should take into consideration the income tax consequences which may flow from transactions entered into. Where the age or health of the taxpayer suggests that the possibility of death is not remote, it is simple prudence to consider the effect of death on the income tax payable by the decedent, his estate, or the beneficiaries thereof.

1. *Partnerships*

It is not uncommon for individuals entering into a partnership agreement to give full consideration to the federal estate tax consequences of the death of one of the partners. It is equally important that all of the partners be aware of the income tax consequences of the death of one of their members. The rather elaborate provisions⁷ in the 1954 Code dealing with taxation of partners were not drafted with the usual partnerships in mind. It is not the purpose of this article to examine these, but merely to suggest that there lies in these provisions the possibility of great inequity if the decedent has not given due attention to them.

6. In *Bankers Trust Co. v. United States*, 178 F. Supp. 267 (S.D.N.Y. 1959), a district court held that such bonds should be valued at the current market value. This was contrary to a prior revenue ruling. Rev. Rul. 156, 1953-2 Cum. Bull. 253. On appeal, the court held that such bonds had to be valued at par rather than at the lower market value. *Bankers Trust Co. v. United States*, 284 F.2d 537 (2d Cir. 1960), cert. denied, 366 U.S. 903 (1961).

7. Int. Rev. Code of 1954, §§ 701-71.

The most obvious problem is produced by the insistence in the 1954 Code that the taxable year of a partnership not close as a result of the death of a partner.⁸ Thus, under ordinary circumstances decedent's distributive share of partnership income for the partnership taxable year in which the decedent dies is includible in the return of his estate rather than in his own return. Although, in some fiscal year situations, this can produce a benefit, the results are ordinarily of potential detriment and may be cured only in part by the action of the executor in the election of a fiscal year and actual distribution of earnings.

By way of example, if a calendar year partner in a calendar year partnership dies in the middle of the year, his distributable income is not determined until the end of the year and then is taxable to his estate. If not physically distributed by the estate to his widow before the end of the year (and this may be impossible), the decedent's *entire* partnership income for that year could be included in the first taxable year of the estate. The estate is entitled to a single exemption and could have no income tax deductions to claim. If the widow lacks income, has many dependents, and has substantial deductible expenses, the resulting exemptions and deductions will not be available to reduce the taxable income received by the partner from the partnership.⁹

It may be possible to cure this defect, where it is anticipated, by having the partners enter into an agreement wherein each partner agrees that upon death his entire interest shall be sold to the partnership. A suggestion that such an agreement could be effective to close the deceased partner's taxable year at his death is found in the regulations.¹⁰ It is clear that without such an agreement, the mere liquidation of the partner's interest as of the date of death will not affect the year of inclusion of partnership income.¹¹

This particular issue cannot be said to have been clearly resolved. For that reason, legislation has been proposed which would create an opposite presumption to that set forth in the present law.¹²

8. Int. Rev. Code of 1954, § 706(c)(1).

9. Treas. Reg. § 1.706-1(c)(3)(ii) (1956).

10. Treas. Reg. § 1.706-1(c)(3)(iv) (1956) states: "If, under the terms of an agreement existing at the date of death of a partner, a sale or exchange of the decedent partner's interest in the partnership occurs upon that date, then the taxable year of the partnership with respect to such decedent partner shall close upon the date of death." See Int. Rev. Code of 1954, § 706(c)(2)(A)(i).

11. Int. Rev. Code of 1954, § 706(c)(2)(A)(ii). See also Int. Rev. Code of 1954, § 736.

12. H.R. 9662, 86th Cong., 2d Sess. § 764 (1960) (Trust and Partnership Tax Revision Act of 1960). No action was taken on this bill in the first session of the 87th Congress. See S. Rep. No. 1616, 86th Cong., 2d Sess. 80 (1960); H.R. Rep. No. 1231, 86th Cong., 2d Sess. 30 (1960).

2. Sales

If, at a time when death is not a remote possibility, the taxpayer contemplates a sale or exchange of property involving gain or loss, his counselor would do well to suggest the income tax effect of completing the transaction. No gain or loss is realized from the mere entering into a contract to sell property or real estate, whether the taxpayer is on a cash or accrual basis.¹³ If a loss on the transaction is contemplated and death is imminent, it is important that settlement be made as quickly as possible. Should death intervene before the closing of the transaction, the property would take a new basis, and there would be no recognition of the loss to the taxpayer to offset his other gains or other income in his last taxable year. On the other hand, if a gain is anticipated, consideration should be given to postponing closing the transaction since the intervention of death will produce a new basis—the sales price—and no taxable gain should result.

In this connection careful attention should be given to the rules with respect to the time of realization of gain or loss. Ordinarily a closed transaction for tax purposes results from a contract of sale under which the vendor is unconditionally obligated to deliver to the buyer a deed upon payment of consideration, and by which the purchaser secures immediate possession and exercises all rights of ownership.¹⁴ The delivery of the deed may be postponed, and payment of part of the purchase price may be deferred.¹⁵ Where gain is anticipated, care should be exercised that it not be considered as accrued, or, in the case of a cash basis taxpayer, constructively received within the provisions of section 451.¹⁶

3. Installment Sale

The possibility that the taxpayer may have the option to report gains, particularly from the sale of real estate, on an installment basis, presents a special problem.¹⁷ If the vendor is of advanced age, careful consideration should be given to the effect of the election should he die during the period when installments are due, and, accordingly, a portion of the gains remains unreported.

Under the 1939 Code, death accelerated the obligation of the decedent

13. O. 988, 2 Cum. Bull. 84 (1920); A.R.R. 13, 2 Cum. Bull. 78 (1920); see Robert W. Ewing, 17 CCH Tax Ct. Mem. 626 (1958).

14. P-H Fed. Tax Course ¶ 2725 (1962).

15. See *Commissioner v. Segall*, 114 F.2d 706 (6th Cir. 1940), cert. denied, 313 U.S. 562 (1941); *Commissioner v. North Jersey Title Ins. Co.*, 79 F.2d 492 (3d Cir. 1935).

16. Int. Rev. Code of 1954, § 451; see Treas. Reg. §§ 1.451-1 to -2 (1957) (particularly § 1.451-1(b)).

17. Int. Rev. Code of 1954, § 453(b).

to include and report the remainder of the gain in his final return.¹⁸ Correspondingly the remaining gains tax constituted a deduction for estate tax purposes.¹⁹ The estate or the person receiving the obligation upon death did have the option of filing a bond with the Commissioner warranting that the gain would be included as income by the receiver of installments when paid in the same manner as would have been reported by the decedent had he survived.²⁰ If the estate was large and most of the gains were unreported at the decedent's death, acceleration of payment of the tax might well be to the benefit of the beneficiaries. The federal estate tax deduction for the capital gains tax could more than offset any benefit to be derived from spreading the gain over the years after the decedent's death and from deducting the estate tax payable with respect to the increment remaining and included in the federal estate at the date of death.²¹

Under the 1954 Code this option is no longer available to the recipient of the installment obligation.²² Death does not constitute a disposition. The estate and the ultimate beneficiary who receives the installment obligation *must* report the income in the same manner as the decedent would have reported it had he remained alive, taking the decedent's basis.²³ At first glance this change may seem beneficial, and in fact it seems that this was the intent of Congress.²⁴ Unfortunately, however, the absence of an election forces the taxpayer to consider the consequences of intervening death on the election to report gain on an installment basis. No plans, which will affect the taxation of the income to the recipient, can be made after death.

The only method by which it may be determined in advance whether it will be to the advantage of the vendor to elect the installment basis is to estimate the federal estate tax to be paid on the remaining capital gains to be included in the decedent's estate. It will then be necessary to take into consideration the income of the recipient and the manner in which he or she is likely to report taxes should the decedent die prior to the completion of the installment payments. It should be remembered that the estate tax payable with respect to the increment remaining at the date of death, in the case of an installment sale, is available only as a deduction and not as a credit. As a deduction it can be used only against regular income and cannot be used

18. Int. Rev. Code of 1939, ch. 1, § 42, 53 Stat. 24.

19. Int. Rev. Code of 1939, ch. 1, § 44(d), 53 Stat. 25.

20. *Ibid.*

21. Int. Rev. Code of 1954, § 691(c).

22. Int. Rev. Code of 1954, § 691(a)(4).

23. Int. Rev. Code of 1954, § 1014(c).

24. H.R. Rep. No. 1337, 83d Cong. 2d Sess. 64 (1954).

to offset capital gains²⁵ if the alternate computation is employed. When the estate is relatively large and the decedent may not survive the date of sale by a substantial period of time, consideration should be given to payment of the capital gains tax at the time of the transaction because this payment in effect reduces the taxable estate.

III. PERIOD OF ADMINISTRATION

A. *General*

As indicated at the outset, we are principally concerned with the opportunities available to an executor or administrator for the saving of estate and income taxes. The most important choices will be those affecting income tax because the character and amount of the estate have been established by the death of the decedent. Before discussing the particular elections available to the executor in both areas, it might be appropriate to make some general observations which, although self-evident, deserve emphasis.

It should be noted that even decisions having to do entirely with the administration of the estate from the probate point of view, may have a definite effect on the ultimate funds available for use by the beneficiaries. Election of the alternate valuation date and choice of the fiscal year discussed in detail below are obvious instances. Care should be exercised, however, that such choices are not made inadvertently and without consideration of the consequences. For example, in some jurisdictions there is provision for a special proceeding where the executor is the sole legatee.²⁶ By filing a special bond, the executor may be permitted to dispense with all formal administration subsequent to qualification. A decision to administer the estate under such a proceeding will save time and reduce administration expenses. On the other hand, it may also fix the date of qualification as the date of distribution. Not only will this affect the optional value election under the estate tax, but it may also prevent any planning for income tax purposes since all estate income will be considered as distributed as of the date of qualification.²⁷ Although the period of administration would be complete in the sense that distribution had occurred, it seems unlikely that the estate would have terminated for income tax purposes until the administration is completed by the preparation of the federal estate, local inheritance, and income tax returns.²⁸

It follows that before making any such decisions, the executor should

25. Int. Rev. Code of 1954, § 1201(b).

26. See, e.g., D.C. Code Ann. §§ 20-203, -303 (1961).

27. I.T. 2925, XIV-2 Cum. Bull. 148 (1935).

28. Treas. Reg. § 1.641(b)-3 (1956), as amended, T.D. 6353, 1959-1 Cum. Bull. 163.

make a careful estimate of the total estate for federal estate tax purposes, of the possible estate and inheritance taxes, and of the source of the funds with which to pay these and other debts. At the same time, he should estimate the likely duration of the administration of the estate, the income to be received, and the expenses which are likely to be incurred during administration. Having made such estimates, the executor or administrator will be in a position to make an informed choice of the alternatives set forth below.

During the period of administration, re-estimates must be made. For example, it is entirely possible that property originally relied upon as a source of funds will have increased greatly in value since the date of death. The imposition of a capital gains tax as the result of this could produce a detriment which would necessitate a change in the plan. Thus, the initial program must be regarded as simply a plan to be adhered to if justified by the result, but to be changed if circumstances indicate the need.

B. *Income Tax*

1. Choosing the Taxable Year

Since most individual taxpayers adopt the calendar year for their own returns, there is a natural tendency for an executor to report on the same basis. If a taxpayer dies on July 1, his executor may, without thinking, file a short-period return from July 1 to December 31 and be on the calendar year basis ever after. Before following his natural inclination, the executor should pause. Under section 441 of the Code, a new taxpayer, such as an estate, may adopt either a calendar or a fiscal year without obtaining the prior approval of the Commissioner.²⁹ A fiscal year is defined as a period of twelve months ending on the last day of any month other than December.³⁰ It has long been held by the Internal Revenue Service that the first return of a decedent's estate may be filed for *any* period of not more than twelve months beginning with the day of the decedent's death.³¹ An executor by filing a return beginning as of the date of the decedent's death and ending at the end of any month except December automatically establishes a fiscal year for the estate.

Why bother with a fiscal year? The answer lies with the reason behind most income tax strategy—the avoidance of too much income in one year; it is the over-accumulation of income that causes high tax rates. Spreading income evenly over the years is a goal to be sought. The taxes produced by an abnormally large net income in one year and an ab-

29. Treas. Reg. § 1.441-1(b)(3) (1957).

30. Int. Rev. Code of 1954, § 441(e).

31. See CCH 1962 Stand. Fed. Tax Rep. ¶ 2751.102.

normally small net income in another year will invariably be greater than those created if the incomes are equally divided.

It may be possible for an estate to avoid this accumulation of income by fragmenting the income of the estate into as many taxable years as possible. In many cases fragmentation is possible only if a fiscal year is chosen. Consider the case of a taxpayer who dies on July 1. If through September of the following year only two substantial amounts of income, \$12,000 in September and \$12,000 in November, are expected in the year of death, the executor might elect a fiscal year beginning October 1 by filing a short period return from July 1 to September 30.³² As a result the estate's income would be divided equally between two taxable years, the total taxes for both years being \$6,344.³³ If an initial calendar year is chosen, the whole \$24,000 falls in the first return, and the tax bill is \$9,206.³⁴ A simple election here could save this estate \$2,862. On the other hand, if the \$24,000 of income of this decedent dying on July 1 will be evenly spread and the administration of his estate can be finished within two years, it may be unwise to adopt a fiscal year. If a calendar year is adopted, the first return is for a period of six months ending December 31. The next return will be for the entire next calendar year, and the final return will be for a period of six months. Thus, two years income is reported as evenly as possible in three separate returns, and three \$600 exemptions are obtained. The taxes for the three periods are:

7/1-12/31	\$1,204 ³⁵
1/1-12/31	3,172 ³⁶
1/1-6/30	1,204 ³⁷
	<hr/> \$5,580

Unfortunately, the executor's choice of a fiscal year may not be as simple as suggested above.³⁸ He must consider distributions to beneficiaries and legatees which will reduce the taxable income of the estate in the year of payment. But he need not be concerned, as in the case of certain distributions by a trust,³⁹ that a subsequent distribution of the

32. Int. Rev. Code of 1954, § 443.

33. Assuming no deductions, the taxable net income for each year would be \$12,000 less exemption of \$600, or \$11,400. The tax thereon is \$3,172.

34. This represents the tax on \$24,000 less the \$600 exemption.

35. This represents the tax on \$6,000 income less the \$600 exemption.

36. This represents the tax on \$12,000 income less the \$600 exemption.

37. See note 35 supra.

38. See Cantwell, *Tax Planning for Estates—Selection of the Tax Accounting Period*, 44 A.B.A.J. 889 (1958).

39. Int. Rev. Code of 1954, § 666.

accumulated income will be taxed to the recipient as if distributed when received by the estate.

Over-accumulation of income can also occur when income and deductions are not synchronized. Sometimes a major portion of the income of an estate is received early in the administration at a time when distributions cannot be made or the major deductible expenses cannot be calculated or paid. Choice of a fiscal year can have the effect of postponing the reporting of income until it can be offset by a deduction. For example, a person dies July 1, and \$20,000 of income is expected November 1, which cannot be offset by anticipated deductions until April 1 of the next year. If the fiscal year, July 1 through June 30, is adopted, the income and deductions will be in the same return. If a calendar year is selected, the income will be in the first return, and the deduction in the next.

The use of the fiscal year to postpone the reporting of income can be helpful even if there will be no deduction to consume it. In the above example, use of the fiscal year gives the executor an additional six months to raise the tax on the \$20,000. The extra time may be important to an estate having no readily saleable asset. Even if the cash is available, the executor has the use of it for the added time. Such an election may also save an executor from the anguish which accompanies the failure to file the first return. If the calendar year deadline, April 15, slips by, the due date may be postponed by choosing a date ending after December 31.

Postponement of reporting income can also lead to fragmentation. In the example of the person dying on July 1, to whose estate a \$20,000 item of income was paid on November 1, there may be several beneficiaries who would share this income. Their tax brackets may be low enough that the tax they pay on the \$20,000, as fragmented, may in the aggregate be smaller than the tax the estate would pay on the whole amount. However, the income would be attributable to them only if there were a distribution of income or corpus.⁴⁰ If a calendar year is chosen, the executor has only six months to make the distribution. In most jurisdictions no distribution can be made within this time because of the possibility of creditors' claims. Selection of a fiscal year ending the next June 30 gives the executor an extra six months to distribute income or corpus and perhaps wind up the estate. The distributees report this income in their returns for the calendar year ending December 31⁴¹ of the year following the death and pay the tax the next April 15. Thus,

40. Int. Rev. Code of 1954, § 662(a).

41. The beneficiary of an estate distributing income reports an amount based upon the distributable net income of the estate in the taxable year ending within or with his taxable year. Int. Rev. Code of 1954, § 662(c).

payment of the tax on income received November 1 has been put off an entire year.

As indicated earlier,⁴² the requirement that a partnership continue for tax purposes after the death of a partner can impose an intolerable burden on the beneficiaries of the deceased partner's estate. Election of a fiscal year may be the means of resolving the dilemma. If a partner whose share of the calendar year income is eventually determined to be \$20,000 died September 1, he may have received and spent one-half thereof prior to his death. If no effective buy and sell agreement has been entered into, all of the partnership income of \$20,000 will be includible in the decedent's estate as if received on the last day of the taxable year.⁴³ Whether or not the \$10,000 received before death can be treated as a distribution to the estate as of the end of the calendar year or to the decedent's widow is not entirely clear.⁴⁴ Even if it is, the remainder of the income is included by an entity (the estate) which probably has few deductions to take against it. It may not be possible at the end of the calendar year to determine exactly what the partnership's taxable income is. What is more important, it may be impossible for the partnership to distribute the income to the estate. In order to make a fair estimate of the tax effects, time will be needed to get the funds in hand so that they may be distributed to the widow or other beneficiaries in such a way as to be taxable to them and so that their exemptions and deductions may be utilized to the full. By electing a fiscal year ending August 31 of the year following death and distributing the partnership income to the widow prior to that date, the executor will delay actual reporting of the income until the widow files her income tax return for that calendar year following death. Further, the income will be taxable to the wife, who should have exemptions and deductions to claim against it which may not be available to the estate.

Where the decedent is a partner, the executor should at the earliest possible moment determine the nature of the partnership, its taxable year, the income already received by the decedent, and the total anticipated for the partnership year. Unless the partner's interest terminates through an effective buy and sell arrangement, all these factors are considerations which should enter into the determination of which taxable year to choose.

The application of the postponement principle is especially useful in the case of an estate having an excess of deductions over income. Losses can be utilized as itemized deductions by the beneficiaries only on termi-

42. See note 8 *supra* and accompanying text.

43. Int. Rev. Code of 1954, § 706(c)(1); see Treas. Reg. § 1.706-1(c)(iii) (1956).

44. See Treas. Reg. §§ 1.662(a)-3, 1.706-1(a) (1956).

nation of the estate.⁴⁵ If a taxpayer dies in July and the estate makes a substantial income tax deductible expenditure in December which will not be offset by income, election of a fiscal year beginning December 1 will give the executor until November 30 of the next year to wind up his affairs and make distribution of the assets and the income loss.

A caveat may be in order here. The Code imposes a calendar year upon a taxpayer keeping no books or having no annual accounting period.⁴⁶ Under the regulations the keeping of formal bound books is not necessary.⁴⁷ All that an estate would need are records which would sufficiently reflect income adequately on the basis of its fiscal year accounting period. However, the estate should adopt as its accounting period before the local probate court, the same period upon which it reports its income tax. There should then be no grounds for the Commissioner to say that the estate's regular accounting period does not qualify as a fiscal year.⁴⁸

2. Timing Income Distributions

Every executor, before the end of his taxable year, should take stock of what income has been collected and how it may be offset by either deductions or distribution. Distribution of income is another technique to avoid accumulation of income in the estate. It is far better that \$10,000 of income be divided among two or more individuals than taxed to one (the estate), assuming the tax brackets of the beneficiaries are low enough to produce an overall saving. Section 661(a)(2) of the Code makes this income splitting possible, allowing estates a deduction for "other amounts" properly paid, credited, or required to be distributed, but not exceeding the distributable net income of the estate.⁴⁹ The term "other amounts" would here refer to that income of the estate which the executor need not, but may in his discretion, distribute.

Thus, if the income of an estate is excessive for any year, consideration should be given to passing it along to the beneficiaries in such manner that their income brackets and that of the estate will be as nearly equal as possible. Of course, a detailed knowledge of all sources of income and deductions of the beneficiaries is necessary. For example, if the estate's net income is \$10,000 for the year and the sole beneficiary has no other income, it will be advisable to distribute \$5,000 to the beneficiary and retain the remainder to be taxed to the estate. If the

45. Int. Rev. Code of 1954, § 642(h).

46. Int. Rev. Code of 1954, § 441(g).

47. Treas. Reg. § 1.441-1(g)(3) (1957).

48. Price, *Post-Mortem Estate Planning*, N.Y.U. 15th Inst. on Fed. Tax 1029, 1035 (1957).

49. Treas. Reg. § 1.661(a)-2(c) (1956).

beneficiary's taxable net income is \$2,000, equalization of incomes will result from a distribution of \$4,000. If there is more than one beneficiary, application of the distribution principle becomes complex. If the tax brackets of the beneficiaries are disparate, a distribution of income may harm one but benefit another. An executor should always attempt to make distributions in a fashion which does justice to all.

It may be possible to shift the tax burden from one beneficiary to another by making uneven income distributions in one year and equalizing them in a later year by a distribution exceeding the distributable net income. Assume an estate has a distributable net income of \$100,000 in 1960 and \$100,000 in 1961. There are two equal beneficiaries, A, an eighty per cent, and B, a twenty-five per cent bracket taxpayer. In 1960, the executor distributes \$50,000 to B and leaves \$50,000 to be taxed to the estate. In 1961, the estate distributes \$100,000 to A and \$50,000 to B. By the end of 1961 each has received \$100,000 of the estate's income. However, what they include as income is as follows:

	A	B
1960	0	\$50,000
1961	\$66,667 ⁵¹	33,333
	<u>\$66,667</u>	<u>\$83,333</u>

Although A and B have received the same amount of income, A will be taxed on \$16,666 less than B.

Consideration should also be given to the qualitative allocation of income among beneficiaries. Unless authority is found in the will, the various types of income (interest, dividends, rents, etc.) are allocated to the beneficiaries in the same proportion that they comprise the distributable net income.⁵¹ If the estate receives \$10,000 of dividends and \$10,000 of tax-free interest and a distribution is made of \$5,000 to A and the same amount to B, A and B are each deemed to have received \$2,500 of tax-free interest and \$2,500 of dividends. However, where the will authorizes the executor to allocate income among the beneficiaries, it may be possible to distribute the taxable income to a low bracket beneficiary, or nontaxable beneficiary such as a charity, and the tax-free interest to a high bracket individual.⁵²

Where realty is a part of the decedent's estate, it may be that no deliberate distribution of income is necessary. In most states real property

50. This figure is that income which bears the same ratio to the distributable net income (\$100,000) as the "other amounts" paid to A (\$100,000) bear to the "other amounts" paid to all beneficiaries (\$150,000). Int. Rev. Code of 1954, § 662(a)(2); see Stern, *The Income Tax Problems of Estates*, N.Y.U. 13th Inst. on Fed. Tax 147, 153 (1955).

51. Int. Rev. Code of 1954, § 662(b).

52. Treas. Reg. § 1.662(b)-1 (1956).

vests in the heirs or devisees immediately upon the decedent's death and is not ordinarily subject to administration unless the personal property is insufficient to pay debts and legacies.⁵³ In such case, the heirs or devisees are chargeable with the income from the real estate without action on the part of the executor,⁵⁴ and that fact must be taken into consideration in the allocation of income. On the other hand, the decedent may devise his realty directly to the executor for such reason as ease of disposition. His will may also direct immediate sale by the executor of the real estate. In either event, the income from the realty is income of the estate and not the distributees.

A word of caution might be appropriate at this point. The executor should be aware that under the 1954 Code income may be distributed by a distribution of what appears as corpus. As we have seen,⁵⁵ section 661(a)(2) gives an estate a deduction for "other amounts" properly paid during the taxable year to the extent of distributable net income. Section 662(a)(2) taxes such amounts to the recipients.⁵⁶ Since the term "other amounts" is broad enough to encompass the distribution of any asset, it was left to section 663 to provide certain exceptions, one of them being a bequest of a specific sum of money or specific property which is paid all at once or in not more than three installments.⁵⁷ Under the regulations,⁵⁸ the test of such a specific bequest is whether the property is ascertainable as of the testator's death. It is ascertainable if the identity of the property is not based on the executor's discretion or subject to the payment of administration expenses not known at the date of death. Under this criterion the distribution of any money or property pursuant to a residuary bequest⁵⁹ or the funding of a trust⁶⁰ may result in ordinary income to the distributee.

53. See *Abbot v. Welch*, 31 F. Supp. 369 (D. Mass. 1940) (Me.); *Guaranty Trust Co.*, 30 B.T.A. 314 (1934) (N.Y.); *George L. Craig*, 7 B.T.A. 504 (1927) (Pa.); Rev. Rul. 59-375, 1959-2 Cum. Bull. 161 (N.C.). However, in some states although realty vests in the heirs at the time of death, it is subject to administration, and income is reportable by the estate. *Estate of B. Brasley Cohen*, 8 T.C. 784 (1947) (Cal.); Rev. Rul. 57-133, 1957-1 Cum. Bull. 200 (Ore.).

54. Int. Rev. Code of 1954, § 641(a)(3).

55. See note 44 *supra* and accompanying text.

56. Int. Rev. Code of 1954, § 102, which exempts gifts and bequests from income, was amended in 1954 to exclude from its purview those bequests treated as a distribution of income under § 661.

57. The other exceptions are amounts paid to or set aside for charity and amounts paid in the taxable year if, because they were credited as of the last day of the preceding year, the estate received a deduction therefor under Int. Rev. Code of 1954, §§ 651, 661.

58. Treas. Reg. § 1.663(a)-1(b) (1956).

59. Specifically, Treas. Reg. § 1.663(a)-1(b) (1956) eliminates a "bequest to the decedent's spouse of money or property, to be selected by the decedent's executor, equal

3. Deducting From the Income

Section 641(b) allows estates generally the same deductions from income as those given individuals.⁶¹ The few expenditures normally made on behalf of an estate⁶² which would not be deductible from income are funeral expenses,⁶³ debts,⁶⁴ and federal income and estate taxes. The list of deductible expenses would include court costs, appraisal fees, brokers' commissions, cost of protecting estate assets, local estate income taxes, interest, attorney's fees, and executor's commissions.⁶⁵ Care should be exercised that all to which the estate is entitled be taken. It is not unexercised that all the deductions to which the estate is entitled be taken. It is not uncommon to overlook the unusual deductions such as a fraction of the federal estate tax paid with respect to income included in the estate.⁶⁶

The ability to deduct administration expenses from income is a very useful tax reducing device.⁶⁷ For example, an estate may have little or no estate tax to pay but may have a great deal of taxable income. The prudent executor will take whatever deductions he can against the estate's income tax return, for they are of no value in the estate tax return.

The executor should consider the proper time to pay the expenses. It is only in the *last* return of the decedent's estate that excess deductions can be utilized against the individual incomes of the recipients.⁶⁸ Ordinarily this should be the year when the executor makes the bulk of his income tax deductible expenditures, rather than in another year,

in value to a fraction of the decedent's 'adjusted gross estate' as a specific bequest. This quotation would certainly apply to a residuary fractional share marital deduction formula. However, at least one writer thinks a properly drafted pecuniary formula could qualify as an exception to "other amounts" under Int. Rev. Code of 1954, § 663(a)(1). Stevens, *Troublesome Will Provisions*, 34 *Taxes* 809, 817 (1956).

60. The funding of a trust of X dollars from the residue would not be the distribution of "other amounts." Rev. Rul. 57-214, 1957-1 Cum. Bull. 203.

61. Treas. Reg. § 1.641(b)-1 (1956). Certain modifications are set forth in Int. Rev. Code of 1954, § 642.

62. Those expenses incurred for an heir would not be deductible. *Frick v. Driscoll*, 129 F.2d 148 (3d Cir. 1942) (fee for work done for an heir by the estate's attorney).

63. *Estate of Orville F. Yetter*, 35 T.C. 737 (1961).

64. *Estate of Jacob S. Hoffman*, 36 B.T.A. 972 (1937).

65. Most expenses will be found deductible under Int. Rev. Code of 1954, § 212. These include those paid for the production or collection of income, for the management, conservation, or maintenance of property held for the production of income, or in connection with the determination, collection, or refund of any tax.

66. Int. Rev. Code of 1954, § 691(c).

67. Int. Rev. Code of 1954, § 2053(a)(2).

68. Int. Rev. Code of 1954, § 642(h).

when they may exceed the income of the estate and be lost. Decision as to the time of payment necessitates knowledge of the tax rates of the heirs. If their rates are normally low, and in one year the estate's rate is high, it may be better not to await the year of termination for payment.

Usually the choice is not so clear cut as in the last example. The estate must pay both an estate and an income tax.⁶⁹ The guiding principle, however, is the same. The executor should utilize his deductions in either the estate or income tax returns so that the combined tax impact is the lowest possible. There is no rule that the expenses of an estate must be taken in one return.⁷⁰ They may be split between the two returns in any manner the executor sees fit, even to the extent of dividing a single expenditure. Generally, the best result comes from some trial and error mathematics. In making a comparison, it should be kept in mind that where the marital deduction⁷¹ is fully utilized, an estate tax deduction is only fifty per cent effective because one-half serves to reduce the marital deduction.

It may be that the personal returns of the beneficiaries will become involved, as in the problem of income distributions. The beneficiaries of an estate are taxed on an income distribution only to the extent of distributable net income.⁷² If the tax rates of the beneficiaries are higher than the rate of the estate with respect to its estate tax or income tax returns, it may be profitable to elect to offset the estate's income by deductions and to cause a distribution of income, which will be tax-free to the recipients. The effect is to use estate deductions against the incomes of the beneficiaries. This choice usually results in an increase of estate tax which the executor might think it necessary to recoup from the tax savings realized by the beneficiaries. Beneficiaries in low income tax brackets may be harmed because of the pro rata reduction of their income distributions due to the increase in federal estate tax. It will be the task of the executor to make them whole, perhaps by requiring a contribution from the high bracket beneficiaries.

An executor who deducts his expenses against income has a further tax saving choice. The estate's income may consist of several varieties, for example, rent (\$5,000), taxable interest (\$4,000), tax-free interest (\$1,000), and dividends (\$10,000). Against these there are commissions of \$10,000 which are to be deducted. Of the fees, \$500 (\$1,000/\$20,000

69. Int. Rev. Code of 1954, § 641.

70. Treas. Reg. § 1.642(g)-2 (1956).

71. Int. Rev. Code of 1954, § 2056.

72. Int. Rev. Code of 1954, § 662(a).

times \$10,000) must be deducted against the tax-free interest.⁷³ However, the remaining \$9,500 may be allocated against the other forms of income as the executor pleases.⁷⁴ It would seem far better to consume the rents and taxable interest with this deduction, rather than the dividends, which have the \$50 exclusion and the four per cent credit. The saving, because of the credit, is four per cent of \$9,450 (\$10,000 minus \$500 minus \$50), or \$378.

An executor should be aware of one unusual effect of electing administration expenses against income. As noted below,⁷⁵ in some wills the share of the surviving spouse is expressed in terms of a fraction of the adjusted gross estate for federal estate tax purposes. Under a Commission ruling,⁷⁶ the adjusted gross estate means the gross estate less the deductions *actually* taken in the estate tax return. If the deductions are taken from income, the adjusted gross estate is increased, and the spouse is entitled to a larger share of the estate than if the deductions had been reported in the estate tax return. In such cases there is a possibility that the distributees whose shares are thereby decreased may have a claim against the surviving spouse.⁷⁷ This would seem equitable since their shares of income and corpus have been distorted by the improper accounting practice of deducting corpus expenses against income.⁷⁸

As indicated,⁷⁹ unless the administration expenses can be used against both the income and estate tax returns of the estate, an election to deduct them against the income tax return normally causes an increase in the estate tax and a decrease in the principal of the estate. Where those who receive the income and the principal are the same, there is no problem. However, if they are different, as where the income beneficiary is a life tenant and his children are the remaindermen, the executor by his election is preferring one over another even though

73. Treas. Reg. § 1.662(c)-4(e) (1956).

74. *Ibid.*

75. See notes 127-28 *infra* and accompanying text.

76. Rev. Rul. 55-643, 1955-2 Cum. Bull. 386. See also Rev. Rul. 55-225, 1955-1 Cum. Bull. 460.

77. Randall, *Consequences of Executor's Elections as to Administrative Expenses*, N.Y.U. 15th Inst. on Fed. Tax 1011, 1023 (1957).

78. However, where the bequest to the surviving spouse is one-half, or some other fraction of the residue, not described in terms of the adjusted gross estate, the property bequeathed is not changed by electing to deduct administration expenses from income. The reason is that the term residue means that share of the estate remaining after the payment of debts, expenses, and legacies. The same logic would seem to apply to a bequest of a share of the residue to a charity in that the charitable deduction would not be altered by deducting administration expenses against income. Estate of Newton B. T. Roney, 33 T.C. 801 (1960); Rev. Rul. 55-643, 1955-2 Cum. Bull. 386.

79. See note 70 *supra* and accompanying text.

he is saving taxes. It may be necessary that some reconciliation between the interests affected be attempted.⁸⁰

4. Limitation on Double Deductions

Section 642(g),⁸¹ in effect, prohibits deduction against the income of any amount allowable as a deduction from the gross estate under sections 2053(a)(2)⁸² and 2054⁸³ unless there has been filed a statement that the amounts have not been *allowed* as deductions from the gross estate, as well as a waiver of the right to have them allowed at any time. This statement in duplicate may be filed at any time before the expiration of the statutory period of limitation of the year for which the deduction is sought.⁸⁴ The regulations⁸⁵ warn that after the statement is filed, all right to claim the expenditure as an income tax deduction against the gross estate is relinquished. Executors should not be hasty in filing these waivers. The better practice may be to wait until at least after the estate tax return has been computed, filed, and audited. Then the executor can visualize both the income and the estate tax and may choose to apply the deduction more wisely than he could have done early in the administration. It should not be improper to file a waiver if the amounts were merely claimed on the estate tax return as long as they are brought to the attention of an agent for disallowance.⁸⁶ In fact, it is difficult to see why any waiver is filed at all until an agent appears to audit the income tax return of the estate. He will certainly present himself before the end of the period for assessment if he is going to appear at all. His appearance then will leave ample time for filing the waiver. If the waiver is not filed before the period runs, the appearance of an agent then should not cause alarm since the time for assessing a deficiency has run.

5. Deductions Related to Income in Respect to Decedents— "Double Deductions"

It is very important to note that section 642(g) does not prohibit the double deduction (from estate and income tax) of *all* estate expendi-

80. Randall, *Consequences of Executor's Elections as to Administrative Expenses*, N.Y.U. 15th Inst. on Fed. Tax 1011, 1022 (1957). As the author points out, an election to deduct expenses against income penalizes any beneficiary who cannot share in the income of the estate, the taxable portion of which is decreased, or otherwise benefit from the decreased income tax liability.

81. Int. Rev. Code of 1954, § 642(g).

82. This section provides for deduction of administration expenses to determine the value of the taxable estate.

83. This section provides for deduction of casualty losses during administration to determine the value of the taxable estate.

84. Treas. Reg. § 1.642(g)-1 (1956).

85. *Ibid.*

86. Rev. Rul. 240, 1953-2 Cum. Bull. 79.

tures. The last sentence states: "This subsection shall not apply with respect to deductions allowed under part II (relating to income in respect of decedents)."⁸⁷ This quotation has reference to certain deductions and credits in respect to decedents under section 691(b),⁸⁸ which allows to the estate of the decedent or to his heirs⁸⁹ a deduction for such expenses as are specified in sections 162, 163, 164, and 212,⁹⁰ relating to expenses, interest, and taxes which would not be allowable to the decedent. A common reason for disallowance to the decedent would be that he was on the cash basis and did not pay them prior to his death. For instance, a decedent's last return on the cash basis could not deduct a bill (deductible under section 212) for tax counsel which had accrued but which remained unpaid at the time of his death. This would be deductible from the estate's income under section 691(b)(1), and being a deduction that is unaffected by the disallowance of double deductions under section 642(g), it would also be allowable as a deduction (a debt) from the gross estate.

The intent of Congress is clear regarding the enactment of section 691(b) and section 642(g). The expenses described therein are not subject to the regular restriction that a deduction which is allowable to the estate is not allowable for income tax purposes. This grant is a logical and proper offset against the inclusion of certain income required under section 691 which may have *also* been included in the estate of the decedent for federal estate tax purposes. Nevertheless, the Commissioner in his administration of the statute has evidenced a reluctance to permit what are sometimes incorrectly described as "double deductions."⁹¹ All that is required by the statute is that the deduction be one of those described in part II⁹² and that it be paid by the estate or the person liable for the amount to be allowable as an income tax deduction.⁹³ The regulations through imprecise use of terms, seem to suggest that the expenses in question must be "accrued" at the date of the

87. Int. Rev. Code of 1954, § 642(S).

88. Int. Rev. Code of 1954, § 691(b).

89. The deduction belongs to the estate or the heirs or beneficiaries depending upon who is liable to discharge the obligation. In a state in which realty passes directly to the devisees, real property taxes accrued to, but not paid by, a cash basis taxpayer, would entitle the devisees and not the estate to the deduction. Treas. Reg. § 1.691(b)-1(a)(2) (1957). If on the other hand, the estate is required under local law to pay these taxes, it would take the deduction. Rev. Rul. 58-69, 1958-1 Cum. Bull. 254.

90. Int. Rev. Code of 1954, §§ 162-64, 212.

91. See Treas. Reg. § 1.691(b) (1957).

92. Int. Rev. Code of 1954, §§ 691-92.

93. Int. Rev. Code of 1954, § 691(b)(2), allows in addition a deduction for depletion to that person receiving the income to which the deduction relates.

decendent's death.⁹⁴ The reference to accrual and to section 2053(a)⁹⁵ must be regarded as descriptive only, the purpose being to emphasize that deductions are available against the estate and the income. It should not be necessary to establish that an item was accrued at the date of death in order that it qualify as a deduction for income tax purposes. The item may be for one reason or another excludible from the gross estate and still constitute a deduction for income tax purposes if it qualifies as a "part II" deduction.

An important example of an expense deductible for estate and income tax purposes is the termination fee charged by a bank upon the death of one who has established an agency account or a revocable inter vivos trust. This fee is deductible upon the estate income tax return as an expense under sections 691(b) and 212⁹⁶ and upon the estate tax return as a debt or exclusion.⁹⁷ It may be necessary to consider the effect of section 265⁹⁸ which denies expenses and interest relating to tax exempt income even as to the commissions on principal. Where tax exempt securities form part of the trust assets, it may be necessary to allocate a portion of the final principal fees on a rational basis to the exempt interest.⁹⁹ The expenses attributable to these are not deductible for income tax purposes.¹⁰⁰

In rare cases the total income and estate tax brackets may be in excess of one hundred per cent. Where a double deduction for these expenses is taken, an estate may appear to make money. Thus, these deductions may at first seem to be a loophole in the structure of the Internal Revenue Code. However, it should be kept in mind that had the decedent been current in the payment of his bills, the expense in question would have been excluded from his estate. Moreover, he would have received a deduction for the expense on his final individual income tax return. To deny this "double deduction" is to penalize those who die before paying deductible bills.

6. Election to Deduct Decedent's Medical Expenses

The executor of an estate has a special election with respect to expenses for the medical care of the decedent. Under section 213(d) he

94. Treas. Reg. § 1.642(g)-2 (1956) states: "Section 642(g) has no application to deductions for taxes, interest, business expenses, and other items accrued at the date of a decedent's death so that they are allowable as a deduction under section 2053(a)(3) for estate tax purposes as claims against the estate, and are also allowable under section 691(b) as deductions in respect of a decedent for income tax purposes."

95. Int. Rev. Code of 1954, § 2053(a).

96. Valerie Norrie Pozzo di Borgo, 23 T.C. 76 (1954).

97. Estate of Morton W. Reed, 8 CCH Tax Ct. Mem. 303 (1949).

98. Int. Rev. Code of 1954, § 265.

99. Valerie Norrie Pozzo di Borgo, 23 T.C. 76 (1954).

100. Ibid.

may elect to use such expenses paid by the estate during the year following death in an income tax return of the decedent, rather than against the gross estate as a claim.¹⁰¹ Under this election the medical expenses are treated as having been paid by the decedent when *incurred*. The executor must file a statement, similar to that required by section 642(g), that the medical expenses have not been allowed as a deduction against the gross estate.¹⁰²

This election is, of course, very valuable to an estate having an estate tax bracket lower than the individual income tax bracket of the decedent. The operation of the election in most estates will be rather simple. The medical expenses will probably relate to a terminal illness and can be deducted in the last return of the decedent. However, where the illness was of long duration, and the medical bills cover a substantial period, the executor may have a factual problem. Since the deduction will be allowed only in a year in which the medical services were rendered, the executor must discover the taxable years to which the services relate. Discussions with the decedent's doctor should provide a basis for allocating his services over the period of his care. In rare situations the medical expense will relate to treatment in a year barred by the statute of limitations.¹⁰³ Section 213(d) does not authorize the opening of this year for the filing of a claim for refund.¹⁰⁴

7. Capital Gains

Ordinarily the sale of property by the executor presents no unique problem, gain or loss being recognized by the estate to the same extent and in the same manner as it is by an individual. The executor should not overlook the fact that his holding period for gains purposes, under ordinary circumstances, begins with the date of the decedent's death.¹⁰⁵ Thus gain on sale of capital assets within six months of the decedent's death will be reported as ordinary income. Where, from an investment point of view, it is desirable that assets which have increased in value be sold before the end of the six-month period, consideration might be given to the effect of electing the optional valuation date even though this may result in an increase of the value of the estate and thus the

101. Int. Rev. Code of 1954, § 213(d).

102. Treas. Reg. § 1.213-1(d)(2) (1957). The waiver must be filed or associated with the return or claim for refund with respect to which the medical expenses are claimed as a deduction.

103. Int. Rev. Code of 1954, § 6511.

104. Treas. Reg. § 1.213-1(d)(1) (1957).

105. *McFeely v. Commissioner*, 296 U.S. 102 (1935); see *Brewster v. Gage*, 280 U.S. 327 (1930).

federal estate tax.¹⁰⁶ The increase in federal estate tax may be more than offset by the decrease in the income tax on the gain.¹⁰⁷

This serves to illustrate the fact that, as mentioned previously,¹⁰⁸ election of the optional valuation date for federal estate tax purposes may have a definite effect on the taxable income of the estate or the beneficiaries thereof. As a further example, where improved investment real property qualifying for the marital deduction is involved, election of the higher value for federal estate tax purposes may be of real over-all benefit. Assume that a decedent's adjusted gross estate has a date of death value of \$160,000, more than half of which is bequeathed to the widow (including an apartment house having a date of death value of \$40,000, three-fourths of which is represented by a depreciable improvement). If the apartment house in question increases in value by an additional \$20,000 within the year after the decedent's death, election of the optional valuation date for federal estate tax purposes will increase the tax by only \$1,400. The taxable estate (prior to the \$60,000 exemption) has increased from \$80,000 (tax \$1,600) to \$90,000 (tax \$3,000),¹⁰⁹ only half of the increase being taxable because of the marital deduction.¹¹⁰ The widow's basis in the property, however, has increased from \$40,000 to \$60,000,¹¹¹ and the depreciable portion from \$30,000 to \$45,000. If we assume a useful life of twenty years from the date of the decedent's death, the annual deductible depreciation will increase by \$750. If the widow is in the fifty per cent income tax bracket, at the end of four years she will have recovered in income tax savings \$1,500 more than the increased federal estate tax, and in eight years, twice that amount. Should she wish to sell the property shortly after the first anniversary of her husband's death at its alternate date value (\$60,000), she will have no capital gains tax to pay. On the other hand, if the date of death value had been used, she would have approximately \$5,000 in gains tax to pay (twenty-five per cent of the increment of \$20,000). In such case, she will have saved \$5,000 in income tax by the payment of an additional \$1,400 in federal estate tax.

Mention should be made of section 303 which permits redemption of certain stock to provide for estate, inheritance, or succession taxes, and funeral and administration expenses. Where the value of all of the stock of the redeeming corporation included in the gross estate is either more

106. The holding period begins at the date of death even though the property is valued as of the optional valuation date. See CCH 1962 Stand. Fed. Tax Rep. ¶ 4724.381.

107. Int. Rev. Code of 1954, §§ 1202, 1222(1).

108. See note 22 *supra* and accompanying text.

109. Int. Rev. Code of 1954, § 2001.

110. Int. Rev. Code of 1954, § 2056.

111. Int. Rev. Code of 1954, § 1014.

than thirty-five per cent of the value of the gross estate or more than fifty per cent of the taxable estate, the stock may be redeemed without dividend consequences in an amount not to exceed the specified taxes, funeral, and administration expenses. Special provision is made for an estate's including the stock of two or more corporations, at least seventy-five per cent in value of the outstanding stock of each of which were owned by the decedent. For the purposes of gain or loss, said stock has the same capital gains status as any other security included in the estate.

8. Terminating the Estate

It should be kept in mind that an estate may terminate for tax purposes before or after it terminates legally.¹¹² Within reason, however, an executor can hasten or delay the administration to the income tax advantage or disadvantage of the beneficiary. For example, if a surviving spouse has \$10,000 of income and the decedent's estate has \$10,000 from securities, it would seem pointless to terminate an estate prematurely. The entire \$20,000 would be taxed to the spouse at a rate greater than the rate on either half. Tax money can be saved every year the estate is in existence. The foregoing assumes that other considerations do not outweigh the advantages of termination. It may be that the surviving spouse has a need for the assets of the estate, which is more important than the dollars saved by fragmenting the income. It may also be that taxes will not be saved by keeping the estate in existence because the surviving spouse has children and may be entitled under section 2 to file a joint income tax return.¹¹³ If so, early termination of the administration may be desirable.

If the surviving spouse is not in financial straits, the effect of termination can be achieved by continuing the administration and making distributions of income. Keeping the estate alive as a taxable entity makes possible the retention of income at rates lower than those of the beneficiaries. However, termination and distribution of the corpus causes the income to be taxed to the beneficiaries and irretrievably destroys any chance of tax maneuvering.

112. It is beyond the pale of this discussion to set forth the rules governing the termination of estates for tax purposes. Generally, an executor cannot by "capricious delay" unduly prolong administration. An urgent excuse is necessary to validate a lengthy administration. Otherwise, the estate is considered terminated for income tax purposes after the expiration of a reasonable time for the performance of the executor's duties, notably, the payment of debts, taxes, and legacies. *Treas. Reg. § 1.641(b)-3 (1956)*, as amended, *T.D. 6353, 1959-1 Cum. Bull. 163*; see *Glassmoyer, Termination Problems of Estates and Trusts: Capital Gains: Carryover of Tax Benefits upon Distribution, N.Y.U. 17th Inst. on Fed. Tax 1227 (1959)*.

113. *Int. Rev. Code of 1954, § 2*.

If, by the terms of the will, a trust is to be established, the executor might consider establishing it during the administration, rather than upon termination, of the estate. A third taxable entity is created and the income is further fragmented. For example, if an estate has securities producing \$15,000 annually, the trust might be funded with enough corpus to realize \$10,000 in income. If he has the discretion, the trustee might distribute \$5,000 of this to the beneficiary. The result is \$15,000 taxed to three taxpayers—the estate, the trust, and the beneficiary of the trust—rather than entirely to the estate alone.

It should be kept in mind, however, that in the year of termination all the income, including capital gain, will be taxable to the beneficiaries. On the other hand, expenses in excess of income are carried over to the beneficiaries only in the year of termination.¹¹⁴

Finally, inadvertant or planned, termination for tax purposes can cause the beneficiaries to be taxed on two years of the estate's income if the estate is on a taxable year different from that of the beneficiary.¹¹⁵ If, for example, the estate is on a fiscal year ending April 30, and the estate "terminates" for income tax purposes the following November 30, a calendar year beneficiary will be taxable on distributions made during the fiscal year ended April 30 (to the extent of distributable net income) *and* on all of the estate's income for the short final fiscal year ended November 30. In addition, the beneficiary will include the December income on the assets received in final distribution. For this reason the executor may, for income tax purposes, wish to withhold distributions during the estate's last full fiscal year before the year of termination.

9. Waiver of Commissions

In many instances an executor for one reason or another will not want the commission which is rightfully his for faithful performance of his duties. The usual reason is that the fiduciary is also the sole beneficiary of the estate, and he would otherwise receive the amount of the commission as a bequest, without the resulting income tax if it had been received for services rendered. A complete waiver or reduction of the commission is entirely permissible, and the fiduciary should not be taxed on any amounts he might be entitled to but did not receive. However, because of a revenue ruling it may be prudent that the executor make his decision with respect to the commission before the performance of any services.¹¹⁶ Under the facts involved in this ruling: Before beginning his duties, an executor entered into an agreement,

114. Int. Rev. Code of 1954, § 642(h).

115. Treas. Reg. § 1.662(c)-1 (1956).

116. Rev. Rul. 56-472, 1956-2 Cum. Bull. 21.

presumably with his estate, to reduce the amount of his compensation. Finally, before he was entitled to the commission, he executed a waiver. The Internal Revenue Service held that the sum he waived would not represent compensation for services constructively received and would not be subject to the gift tax.¹¹⁷ The implication is that action should be taken before the executor earns and has an absolute right to his commission; otherwise the doctrine of constructive receipt may apply.

10. Payment of a Legacy in Kind

An executor often must decide whether to sell the property of the estate and distribute the proceeds or to make distribution in kind. The satisfaction of a bequest of a specific item of property or of a fractional share of an estate may be made without the imposition of the capital gains tax even though the property has appreciated since the decedent's death.¹¹⁸ On the other hand, the transfer of appreciated or depreciated property in satisfaction of a bequest of a specific sum of money results in gain or loss to the estate, just as though a sale had been made.¹¹⁹ Logically, the legatee obtains a basis in the property equal to the value at the date of distribution, rather than at the date of death,¹²⁰ the rationale being that the legatee of a specific sum of money has a charge against the estate. The satisfaction of that portion of the charge which exceeds the estate's basis in the property is tantamount to a sale or other disposition and is a direct benefit to the estate. But for the appreciation the estate would have had to sell additional property to fulfill the legacy.¹²¹ However, the legatee of specific *property* or of a fractional share of the estate, rather than the estate, is the beneficiary of any appreciation or depreciation.

Despite the seeming clarity of the principle, it is not always easy to determine what constitutes a gift of a specific sum of money. A great deal of trouble has been experienced by practitioners in the area of the

117. *Ibid.*

118. Rev. Rul. 55-117, 1955-1 Cum. Bull. 233, holding that the distribution of appreciated stock pursuant to the terms of a trust established by a residuary clause in a will was not equivalent to a sale or exchange of the stock and did not cause the appreciation to be taxed to the trust or to the beneficiary as a capital gain.

119. *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940); *Suisman v. Eaton*, 15 F. Supp. 113 (D. Conn. 1935), *aff'd mem.*, 83 F.2d 1019 (2d Cir. 1936), I.T. 3316, 1939-2 Cum. Bull. 186. It should be noted that this doctrine has been extended to impose a capital gains tax when appreciated property is distributed which the testator directed in his will to be sold. *Commissioner v. Brinckerhoff*, 168 F.2d 436 (2d Cir. 1948).

120. *Commissioner v. Brinckerhoff*, 168 F.2d 436 (2d Cir. 1948); *Sherman Ewing*, 40 B.T.A. 912 (1939).

121. See *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931).

marital deduction formula bequest.¹²² This is a bequest in which a spouse seeks to leave his mate only that amount of money or property necessary to obtain the exact deduction permissible in the federal estate tax return. It is, of course, a very useful device to avoid oversubscribing the marital deduction and putting too much property in the estate of the second spouse to die. The first published ruling in the area was Rev. Rul. 56-270,¹²³ a short, enigmatic pronouncement concerning a bequest to a spouse of an "amount sufficient to utilize the marital deduction to the maximum extent. . . ."¹²⁴ The ruling held that in satisfying this bequest of a fixed "dollar amount" with appreciated property, the estate realized capital gain (or loss) measured by the difference between the value of the property on the date of distribution and the value on the date of death (or the alternate valuation date).¹²⁵

Fortunately, the Internal Revenue Service amplified this ruling by promulgation of Rev. Rul. 60-87.¹²⁶ The significance of this latter ruling is the official recognition of a marital deduction formula other than the pecuniary type referred to in Rev. Rul. 56-270. This is the fractional share clause, in which a fraction of the residue is left to the surviving spouse, rather than a bequest of a percentage of the adjusted gross estate as in Rev. Rul. 56-270. Under the pecuniary clause¹²⁷ the legatee receives assets of a definite amount at the time of distribution. However, the legatee of a fractional share formula clause receives a fraction of the residuary estate¹²⁸ as it is constituted at the time of distribution. If this concept is difficult to understand, it might be simpler to state that the

122. Int. Rev. Code of 1954, § 2056.

123. Rev. Rul. 56-270, 1956-1 Cum. Bull. 325.

124. *Ibid.*

125. *Ibid.*

126. Rev. Rul. 60-87, 1960-1 Cum. Bull. 286.

127. A pecuniary formula clause might begin: "[I give to] . . . an amount equal to 50% of the adjusted gross estate as finally determined for Federal estate tax purposes. . . ." Cox, *Types of Marital Deduction Formula Clauses*, N.Y.U. 15th Inst. on Fed. Tax 909, 927 (1957).

128. A residuary formula clause might, however, begin: "[From the residue of my estate] I give to . . . that fractional share of my residuary estate which will equal the maximum estate tax marital deduction (allowable in determining the Federal estate tax on my gross estate for Federal estate tax purposes). . . ." Cox, *supra* note 127, at 937. Rev. Rul. 60-87, 1960-1 Cum. Bull. 286 emphasizes that Treas. Reg. § 1.663(a)-1(b)(1) (1956) defining a gift of a specific sum of money for the purpose of denying a deduction for income tax purposes, is not to be used as the criteria for distinguishing between marital deduction formula clauses. These regulations state that if the legacy is dependent upon the payment of administration expenses or otherwise cannot be computed on the date of death (such as a bequest of a fraction of decedent's adjusted gross estate), the bequest is not specific. Under this rule the pecuniary clause would probably not be a bequest of specific property.

pecuniary formula legatee receives a fixed amount whether the assets are up or down at the time of distribution, whereas the fractional share legatee bears the burden of any appreciation or depreciation. No sale or other distribution is deemed made upon the distribution of property to the legatee of a fractional share bequest, because the estate derives no benefit or detriment from appreciation or depreciation.

This last statement has real significance for the spouse who must suffer the consequences of appreciation or depreciation. Consider an adjusted gross estate worth \$500,000, of which the legatee of a pecuniary formula would receive \$250,000. If, at the date of distribution, the value of the property has declined to \$250,000, the spouse could conceivably receive all of the testator's estate. If, however, the estate appreciates to \$1,000,000, the spouse still receives \$250,000. The operation of the fractional share formula, where the surviving spouse shares in the fortunes of the estate, is entirely different. Using the figures in the above example, the spouse's share is half of the residue.¹²⁹ If, upon distribution, the residue is equal to \$1,000,000, the spouse will receive \$500,000 in cash if the assets are sold just before distribution, or an undivided half interest in assets worth the same amount. By the same token, her interest may drop below \$250,000 if at distribution the assets are worth less than \$500,000.

It may be worthwhile to note here that an executor may avoid the capital gain on distribution of property to a pecuniary formula legatee by allocating the appreciated assets to a different legatee, such as a lifetime trust for the surviving spouse which does not qualify for the marital deduction. These assets will not be in the estate of the surviving spouse, where their high value would cause an excessive estate tax. In respect to allocation, the executor seems to have more freedom of action with a pecuniary clause than with a fractional share formula, where he is, in most cases, bound to distribute to the residuary legatees fractional shares of all the assets.¹³⁰

Some marital deduction formulas contain the additional provision that in computing the value of property for distribution, an executor shall use the values finally established in the federal estate tax proceeding. When used with a pecuniary formula, this clause has the effect of allowing the surviving spouse to participate in both appreciation and depreciation and should nullify the possibility of capital gains or loss on distribution in kind. At the same time it presents the executor with additional

129. It is assumed for purposes of simplicity that the adjusted gross estate is equal to the residue. Normally, the residue does not equal the adjusted gross estate, and the fraction is complex. For problems in this connection, see Cox, *supra* note 127, at 935-36.

130. Stevens, *Troublesome Will Provisions*, 34 *Taxes* 809, 817 (1956).

difficult decisions. An executor fulfilling the requirements of a pecuniary clause may allocate certain assets to the surviving spouse. If estate tax values are to be used, the executor may have the embarrassing choice of allocating to the spouse property which has appreciated or depreciated in value for federal estate tax purposes.¹³¹ In other words, he may give the spouse a nickel for a dime or a dime for a nickel. It should be apparent that where federal estate tax values control for distribution purposes use of the optional valuation date could have a substantial effect.

C. Estate Tax

1. Alternate Valuation

The most obvious estate tax election¹³² available to an executor is that of valuing *all*¹³³ the property in the estate as of one year after the decedent's death rather than as of the date of death. Property distributed, sold, exchanged, or otherwise disposed of within the year is instead valued alternately as of the date of disposition. This election is of particular advantage in deflationary periods. Planning with this consideration in mind can cause a lower gross estate and a reduced estate tax.

The election is normally made by placing an "X" in the box in item 23 on page 5 of the estate tax return (Form 706). However, an election can be considered to have been made on the basis of other facts such as computation of the estate tax by the alternate method.¹³⁴ Nevertheless, it must be made by a properly executed return¹³⁵ filed on time or within any extension. An election unwisely made can be remedied by filing a timely amended return.¹³⁶

131. If an asset in the estate is valued at \$100,000 for estate tax purposes and at distribution is worth \$200,000, the executor can fill out the bequest with this asset at the former value. The spouse receives for \$100,000 property worth \$200,000. See Bernstein, *Consideration and Reconsideration of the Marital Deduction*, N.Y.U. 17th Inst. on Fed. Tax 1141, 1145-46 (1959).

132. Int. Rev. Code of 1954, § 2032.

133. The executor cannot elect with respect to just those assets which have decreased in value. He must value all the property alternately or not at all. *Rosenfield v. United States*, 156 F. Supp. 780 (E.D. Pa. 1957), *aff'd*, 254 F.2d 940 (3d Cir.) (per curiam), cert. denied, 358 U.S. 833 (1958).

134. Rev. Rul. 61-128, 1961 Int. Rev. Bull. No. 28, at 7.

135. *Estate of Frederick L. Flinchbaugh*, 1 T.C. 653 (1943); E.T. 14, 1940-1 Cum. Bull. 221.

136. Rev. Rul. 54-445, 1954-2 Cum. Bull. 301. The ruling notes that the estate may be estopped from revoking the election where the executor has been discharged from personal liability, Int. Rev. Code of 1954, § 2204, or where it has entered into a closing agreement, Int. Rev. Code of 1954, § 7121.

Even in times of rising values the alternate valuation should be considered.¹³⁷ The basis for property in the hands of a beneficiary is the value at the date of death or a year thereafter, whichever has been elected.¹³⁸ In some cases the increase in the estate tax, because of value added during the year following the decedent's death, may be more than offset by a reduction in capital gains tax upon sale of the property, or by an increased basis for depreciation. A saving would seem to follow automatically in the case of nontaxable estates. However, the position of the Internal Revenue Service is clear that where the gross estate does not exceed \$60,000, no return need be filed,¹³⁹ and that any return filed voluntarily will not be recognized as effective for purposes of the election of the alternate valuation date.¹⁴⁰ On the other hand, if the gross estate is over \$60,000, the election should be recognized although deductions reduce the gross estate to a nontaxable \$60,000.

As previously stated,¹⁴¹ if the executor distributes, sells, exchanges, or otherwise disposes of the property during the year after the decedent's death, the date of this act is the alternate valuation date.¹⁴² A disposition does not take place if the assets merely change form, such as an exchange of estate assets for stock under section 351,¹⁴³ or a reorganization described in section 368(a).¹⁴⁴ A disposition would not take place by a transfer in which the ownership is not relinquished, as for example, a conveyance of joint property to a revocable trust by the surviving tenant.¹⁴⁵ Nor is the division of a revocable trust into shares to facilitate the payment of income considered a disposition.¹⁴⁶ In most jurisdictions real estate and other property held jointly by the decedent and another with right of survivorship passes to the heirs or to the surviving tenant immediately upon the decedent's death. This is not the type of disposition referred to in section 2032(a)(1).¹⁴⁷ Both realty and jointly held property may be valued by the alternate method even though they pass from the control of the executor and are not subject to administration.¹⁴⁸

137. A decrease in value is not a prerequisite to an alternate valuation. *Treas. Reg.* § 20.2032-1(b)(1) (1958); *Rev. Rul.* 55-333, 1955-1 *Cum. Bull.* 449.

138. *Int. Rev. Code of 1954*, § 1014(a).

139. *Int. Rev. Code of 1954*, § 6018(a)(1).

140. *Rev. Rul.* 56-60, 1956-1 *Cum. Bull.* 443.

141. See note 138 *supra* and accompanying text.

142. *Int. Rev. Code of 1954*, § 2032(a)(1).

143. *Int. Rev. Code of 1954*, § 351.

144. *Treas. Reg.* § 20.2032-1(c)(1) (1958).

145. *Rev. Rul.* 59-213, 1959-1 *Cum. Bull.* 244.

146. *Rev. Rul.* 57-495, 1957-2 *Cum. Bull.* 616.

147. *Int. Rev. Code of 1954*, § 2032(a)(1).

148. *Estate of Minnie S. Pridmore*, *CCH Tax Ct. Rep.* (20 *CCH Tax Ct. Mem.*) 47 (1961) (real estate); *Rev. Rul.* 59-213, 1959-1 *Cum. Bull.* 244 (joint property). If the

What the heir or surviving tenant does with the property, not the event passing the title to them, however, is the critical factor. The turning point with property transferred in contemplation of death is also whether the donee held or disposed of it during the year.¹⁴⁹ It can be seen, then, that others beside the executor have an influence on the alternate values.

Because the alternate valuation date may be the date of disposition, an executor should be wary of terminating the administration prior to a year from the decedent's death. Particular caution should be exercised when the estate consists of volatile securities. It would be an embarrassed executor who rushes headlong to make distribution of the assets only to find later they have declined in value.

In some jurisdictions the probate laws may allow a simplified form of administration in which an executor or administrator under a special bond assumes the responsibility for the payment of debts and legacies, does not file an inventory, and does not render an account to the probate court.¹⁵⁰ If the fiduciary is the sole beneficiary of the estate, the Internal Revenue Service considers the administration terminated and the estate distributed for income tax purposes as of the time the bond is approved.¹⁵¹ It should follow that this is the optional alternate valuation date for estate tax purposes. An executor should decide before he chooses the special bond whether he may use the alternate valuation date.

Property interests, which are affected by mere lapse of time, are valued as of the date of death and are adjusted for any difference in value not due to the lapse of time as of the alternate valuation date.¹⁵² These would include such interests as estates *per autre vie*, remainders, annuities,¹⁵³ and patents. As an example, the life of a patent is seventeen years, and its value will necessarily decrease upon the lapse of a year. On the other hand, the property underlying this interest may decrease for reasons other than the passage of time. In valuing these interests by the

executor enters into a contract to sell the decedent's realty, apparently the date of his contract is the alternate valuation date, not the date the deed is delivered. See 1 Fed. Est. & Gift Tax Rep. ¶ 1230.20 (1961).

149. Price, Alternate Valuation Date Problems, N.Y.U. 17th Inst. on Fed. Tax 1245, 1263-65 (1959).

150. See, e.g., D.C. Code Ann. §§ 20-203,-303 (1961).

151. I.T. 2925, XIV-2 Cum. Bull. 148 (1935).

152. Int. Rev. Code of 1954, § 2032(a)(3).

153. Reference is made to annuities purchased by the decedent in which payments will extend after his death to a beneficiary. The alternate value will be the cost of replacement a year after death. Estate of Judson C. Welliver, 8 T.C. 165 (1947). If the beneficiary dies during the alternate valuation period, the alternate value is the cost of replacement on his death. The difference should be the value of the interim payments, the decrease due to mere lapse of time. Estate of John A. Hance, 18 T.C. 499 (1952).

alternate method, the value as of a year later is used with any decrease caused automatically by time mathematically stricken.¹⁵⁴

As should be expected, the Code¹⁵⁵ prevents the use of the alternate valuation date as a vehicle to obtain double deductions. Losses under section 2054¹⁵⁶ and expenses of administering property not subject to claims under section 2053(b)¹⁵⁷ are allowed only to the extent they do not influence alternate valuations. Also, charitable and marital deductions must reflect the alternate value of property passing to charity and the surviving spouse.

Since the alternate valuation date should not reflect an automatic decrease in value, neither should it reflect an unpreventable increase. The terms "included property"¹⁵⁸ and "excluded property"¹⁵⁹ are used, the former describing an interest embraced in the alternate valuation, the latter, those interests omitted. In general, "excluded property" refers to property earned or accrued (whether received or not) during the year after death on property interests existing at the time of death.¹⁶⁰

154. Treas. Reg. § 20.2032-1(f) (1958). In one example given, a patent with an unexpired term of ten years is valued at date of death at \$78,000. Six months later it was sold for \$60,000. The alternate value is \$60,000 times 10/9.5 (the ratio of the life of the patent on the date of death to its life on date of sale), or \$63,157.89. Treas. Reg. § 20.2032-1(f)(2) (1958).

155. Int. Rev. Code of 1954, § 2032(b); Treas. Reg. § 20.2032-1(g) (1958).

156. Int. Rev. Code of 1954, § 2054.

157. Int. Rev. Code of 1954, § 2053(b).

158. Examples of included property are: Ordinary dividends declared to stockholders of record on or before decedent's death, Treas. Reg. § 20.2032-1(e) (1958); interest and rents accrued to the date of death, *ibid*; appreciation in cattle and farm crops after the date of death (in such a case, feed on hand is disposed of when fed to the livestock, the expense of care being deductible administration expenses), Rev. Rul. 58-436, 1958-2 Cum. Bull. 366; rights to subscribe to stock when they are sold (here, the exercise of the right before the year expires is a disposition. The right is valued at such time, and is equal to the excess of the fair market value of the stock acquired over the subscription price), Rev. Rul. 58-576, 1958-2 Cum. Bull. 625; distribution in partial liquidation of a corporation except to the extent made out of earnings and profits since the decedent's death, Treas. Reg. § 20.2032-1(d)(4) (1958); dividends declared during the alternate valuation period upon stock selling ex-dividend as of a year after death, Rev. Rul. 60-124, 1960-1 Cum. Bull. 363; principal payments on mortgages during the alternate valuation period, since these reduce the value of the obligation, Rev. Rul. 58-576, 1958-2 Cum. Bull. 625; and stock dividends declared after date of death, *Schlosser v. Commissioner*, 277 F.2d 263 (3d Cir.), cert. denied, 364 U.S. 819 (1960).

159. Examples of excluded property are: interest and rents accrued after date of death, Treas. Reg. § 20.2032-1(d)(1)-(2) (1958); ordinary dividends declared prior to death but payable to stockholders of record after date of death (however, in such a case, where the stock is selling ex-dividend at the date of death, this dividend should be added to the ex-dividend quotation on the date of death but not as of a year later), Rev. Rul. 54-399, 1954-2 Cum. Bull. 279.

160. Treas. Reg. § 20.2032-1(d) (1958).

This subject should not be left without noting that the ability to choose between two valuation dates can be an instrument of powerful proportions in a nontax sense. Where a marital deduction formula clause is used, the share of the surviving spouse is based upon values used in computing the tax in the federal estate tax return. These clauses are of two main types, the pecuniary and the fractional share varieties. When the pecuniary kind is employed, it would seem that the surviving spouse is under a distinct disadvantage if the optional valuation date is chosen. Assume an adjusted gross estate valued at \$500,000 on the date of death. This depreciates to \$250,000 a year later, and the executor elects the alternate valuation date. By this act the surviving spouse has become entitled to \$125,000 instead of \$250,000. By use of a provision that distribution shall be made at values established in the estate tax proceeding, the nature of the pecuniary formula can be altered so that the surviving spouse shares in both appreciation and depreciation of assets. However, the alternate valuation date is used almost solely if there has been depreciation. However, some advantage can be seen if the assets of the estate increase after the alternate valuation date and before the date of distribution. If, three years after death they are worth \$1,000,000 (assuming an even increase of fourfold), she would, upon distribution, receive assets valued alternately at \$125,000, but worth \$500,000.

The beneficiary of a fractional share bequest fares better. If the alternate value is chosen, the spouse still retains her position relative to the adjusted gross estate. Her destiny is to receive a fraction of the residue. This fraction should be the same whether the estate has decreased during the year after death or not. In the example above, the spouse's share is the same whether or not the election is exercised. If it had not been exercised and the estate has been distributed as of a year later, her portion of the estate would still be that fraction of the residue equal to the maximum marital deduction. What she receives is less than what she would have gotten on the date of death, but this is due solely to a decrease in values.

2. Deductions

a. General

The executor has the option of charging most administration expenses against the gross estate for federal estate tax purposes.¹⁶¹ He may also elect to treat certain medical expenses as estate tax deductible debts or as income tax deductions of the decedent when incurred.¹⁶² Finally,

161. Int. Rev. Code of 1954, § 2053.

162. See notes 102-04 *supra* and accompanying text.

those expenses related to income in respect to a decedent may be deducted or excluded for estate tax purposes even though they are also deductible against the estate's income.¹⁶³

b. Deduction of State and Foreign Death Taxes

If at least part of the decedent's estate goes to charity, an executor might find the election provided in section 2053(d) to be of real value. Under this election¹⁶⁴ the executor may deduct state¹⁶⁵ (including territories and the District of Columbia) or foreign death taxes imposed upon a transfer to a charity,¹⁶⁶ if either, (1) the entire resulting decrease in federal estate tax inures to the benefit of the charity, or, (2) the federal estate tax is equitably apportioned among all the transferees of included property.

This election is of major importance to small but taxable estates which must pay death taxes on charitable bequests. The table providing the credit for state death taxes begins only when the taxable estate is \$40,000.¹⁶⁷ State and foreign death taxes are generally imposed on transfers of much lower value. The end result is that no relief from these death taxes would be obtainable except in the form of a deduction from the gross estate. Even when the credit becomes applicable, the limitations set by the table are such that a deduction may save more estate tax than the credit. In larger estates, the deduction of these state death taxes serves to preserve the extent of the charitable bequest, particularly where the inheritance taxes on beneficiaries other than the charity exceed the federal credit.

It is a principle of federal estate tax law that a deduction against the gross estate may be had only for amounts actually passing to charity.¹⁶⁸ If state and federal taxes are payable from property which is the subject of a charitable bequest, the deduction on the federal return is limited to the amount finally going to the charity after the payment of these taxes.¹⁶⁹ In such case the executor is confronted in his computation of the federal estate tax by algebra or trial and error with a steadily

163. Int. Rev. Code of 1954, § 691(c)(1).

164. It must be made by filing a written notification to the district director with whom the return was filed before the period prescribed for assessment in Int. Rev. Code of 1954, § 6501. Treas. Reg. § 20.2053-9(c) (1958).

165. The deduction is in lieu of the credit provided in Int. Rev. Code of 1954, §§ 2011, 2014. An election to deduct foreign death taxes is a waiver of the right to a credit under a treaty with a foreign country.

166. Int. Rev. Code of 1954, §§ 2055, 2106(a)(2).

167. Int. Rev. Code of 1954, § 2011(b).

168. See 3 P-H *Inh. & Trans. Tax Serv.* ¶ 120556 (1959).

169. Treas. Reg. § 20.2055-3(a) (1958).

decreasing charitable deduction and a steadily increasing estate tax.¹⁷⁰ The taxes reduce the bequest to charity and cause an increase in federal estate tax, which in turn reduces the bequest to charity and increases the federal estate tax. The executor may find that the increased estate tax may be greater than the credit for the state tax imposed on the charitable transfer.

Section 2053(d) was meant to stop such pyramiding of the federal estate tax in two circumstances. The first occurs where the decrease in federal estate tax, as a result of the election, inures solely to the benefit of the charity.¹⁷¹ For example, the will of a decedent bequeaths all the residue to a charity. If this residue bears the burden of paying the federal estate tax, it follows that any decrease in estate tax as the result of the election must inure solely to the benefit of the charity.¹⁷² The pyramiding with respect to the state tax is halted when the state tax is deducted because there is no longer a federal estate tax payable with respect thereto.¹⁷³

In the second instance, the deduction will be allowed if the federal estate tax is equitably apportioned among all the beneficiaries.¹⁷⁴ The federal estate tax is considered equitably apportioned if each transferee's share of this tax is based upon the net amount of his bequest subject to the tax.¹⁷⁵ The result of this requirement is that the decrease in estate tax through operation of the election will inure to the charity even though other beneficiaries may incidentally benefit, as by a lowering of the tax rate. For example, a decedent leaves the residue of his estate in three shares to his two sons and a charity. If this residue bears the payment of federal estate taxes as an administration expense, any decrease in federal estate tax resulting from an election to deduct the state death taxes on the charitable transfer will inure to the benefit of two sons as well as the charity, and the deduction will not be allowed.¹⁷⁶ However, if each legatee bears his share of the federal estate tax based upon the net amount of his bequest, the decrease in estate tax will

170. S. Rep. No. 1401, 84th Cong., 2d Sess. 3 (1956).

171. Int. Rev. Code of 1954, § 2053(d)(1).

172. Treas. Reg. § 20.2053-9(e)(1) (1958).

173. Assume a gross estate of \$500,000, deductions of \$100,000, a bequest of the residue to charity, and a state death tax upon the residue of \$25,000. If the deduction is elected, the charitable deduction (amount of the residue) is \$375,000, which is exactly what the charity actually receives (omitting consideration of the federal estate tax). If the state death tax is taken as a credit, the charitable deduction is \$400,000, less than what the charity receives, and the pyramiding begins.

174. Int. Rev. Code of 1954, § 2053(d)(2).

175. Treas. Reg. § 20.2053-9(b)(2) (1958).

176. Isaac G. Darlington, 36 T.C. No. 62 (June 30, 1961).

necessarily inure only to the charity.¹⁷⁷ For this reason, the pyramiding ceases if the deduction is elected. In another illustration, if the charity has the remainder interest after a life estate in an individual, the decrease in estate tax inures to the individual (because the corpus and his income is increased), and the deduction is not allowable.¹⁷⁸

As with most elections, the only real answer is to make two computations. In some cases, the deduction of the state death taxes may create a larger estate tax.

c. Payment of Claims

Section 2053 allows a deduction against the gross estate for funeral and administration expenses, claims, and unpaid indebtedness in respect to property included in the gross estate.¹⁷⁹ Under the 1939 Code these deductions were limited to the value of such property in the decedent's estate as was "subject to claims."¹⁸⁰ This phrase has reference to property which under local law bears the burden of the payment of these deductions in the settlement of the estate.¹⁸¹ In most cases it is the probate property of the estate. Examples of property not subject to claims might be jointly held property, proceeds of life insurance, property over which the decedent had a testamentary power of appointment, transfers in contemplation of death,¹⁸² and certain other transfers in which the decedent retained enjoyment over the property.¹⁸³ The foregoing is a general rule only. Each case presents the specific problem whether under local law the creditors of the estate can reach the property.¹⁸⁴ The inequity of this rule is only too apparent. A person may die leaving only real estate held jointly with his wife and not subject to claims. This property may be included in full in his gross estate, yet be unreduced by the usual and unavoidable expenses which the survivor will undoubtedly pay.

177. A testator leaves \$100,000 each to A, B, and a charity, upon whom the state imposes a tax of \$15,000. The federal estate tax is to be apportioned upon the basis of the net bequest includible in the taxable estate. The charitable deduction as a result is \$35,000. No federal estate tax can be apportioned to the charity since its net bequest (\$35,000) is not includible in the gross estate. Since the federal estate tax is paid wholly by A and B, the deduction is allowable.

178. Treas. Reg. § 20.2053-9(e) (4) (1953).

179. Int. Rev. Code of 1954, § 2053.

180. Int. Rev. Code of 1939, ch. 3, § 312(b), 53 Stat. 123-24.

181. Treas. Reg. § 20.2053-1(c) (2) (1953).

182. Int. Rev. Code of 1954, § 2035.

183. Int. Rev. Code of 1954, §§ 2036-38.

184. See Estate of Samuel Hirsch, 14 T.C. 509 (1950), in which personal property held by the decedent and his wife jointly was under New York law available to creditors and was "property subject to claims."

In 1954 Congress recognized this injustice and provided the exception that deduction for funeral and administration expenses, claims, and unpaid indebtedness may exceed the value of property subject to claims to the extent they are paid *before* the date for filing the estate tax return.¹⁸⁵ The regulations are clear that these deductions must be paid *out* of property not subject to claims.¹⁸⁶ It should not be necessary, however, that the surviving spouse liquidate the real estate held jointly and pay the expenses from the proceeds. It should be sufficient if she, as the person acquiring the property by right of survivorship, pay them out of other funds belonging to her.¹⁸⁷ It is important to note that no deduction is given for an expense paid out of property not subject to claims after the filing date of the return. For instance, the decedent had a bank account of \$5,000 subject to claims and insurance of \$100,000 not subject to claims. The surviving spouse pays expenses of \$2,000 (\$1,000 from the insurance and \$1,000 from the bank account) before the filing date of the estate tax return and \$7,000 from the insurance after the filing date. The deductions are limited to \$6,000, representing \$1,000 from the insurance paid before the filing date and \$5,000, the extent of the property subject to claims, which can be consumed by deductions at any time.¹⁸⁸ The other \$1,000 paid before the filing date cannot be deducted because it was not paid out of the property not subject to claims.

It might seem that the requirement of paying the expense before the filing date works an injustice to a decedent owning jointly-held realty not subject to claims but subject to a mortgage for which the estate is personally liable. The correct method of reporting the property is to list its full value in Schedule E of the estate tax return and to take as a deduction on Schedule K (claims) the amount of the mortgage.¹⁸⁹ The question is whether the surviving spouse would have to pay off this mortgage before the filing date of the return in order to obtain a deduction for the indebtedness under section 2053(c)(2). The answer is not wholly clear, but it seems to be found in the following sentence defining property subject to claims:

For purposes of this section, the term "property subject to claims" means property includible in the gross estate of the decedent which, or the avails of which, would

185. Int. Rev. Code of 1954, § 2053(c)(2).

186. Treas. Reg. § 20.2053-1(c) (1958). An extension of time for filing the return will prolong the period.

187. Treas. Reg. § 20.2053-1(c)(2)(1) (1958).

188. Treas. Reg. § 20.2053-1(c)(2)(2) (1958).

189. Treas. Reg. § 20.2053-7 (1958). If the decedent's estate is not liable for the mortgage, only the equity of redemption is included in Schedule E. See *Estate of Harcourt Johnstone*, 19 T.C. 44 (1952).

under the applicable law, *bear the burden of the payment of such deductions* in the final adjustment and settlement of the estate, except that the value of the property shall be reduced by the amount of the deduction under section 2054 attributable to such property.¹⁹⁰

The jointly-held realty while not *generally* subject to claims is, however, subject to the particular claim for which the deduction is sought, namely, the mortgage, and for purposes of *this* deduction can be considered as property subject to claims. The surviving spouse should not have to pay off the mortgage.

The 1954 Code allowed another kind of deduction for the first time. Expenses are often incurred in *administering* property which is not subject to claims but which is includible in the gross estate of a decedent. An example would be a revocable inter vivos trust established by the decedent.¹⁹¹ The assets of this trust may be subject to a trustee's commission or an attorney's fee incurred to contest the inclusion of this property in the gross estate.¹⁹² Under section 2053(b) these would be deductible to the same extent as the expenses previously discussed. Only those expenses "occasioned by the decedent's death and incurred in settling the decedent's interest in the property or vesting good title to the property in the beneficiaries"¹⁹³ are countenanced as deductions. Those expenses incurred for the benefit of the heirs are not deductible. A further prerequisite is that the expense of administering property not subject to claims be paid within the period of assessment provided in section 6501, normally three years after the due date of the return. This period would be subject to any extension provided in section 6503.¹⁹⁴

Finally, it should be noted that the Commissioner, as might be expected, has attempted to narrow the definition of deductible claims against the estate "allowable by the laws of the jurisdiction."¹⁹⁵ In long standing regulations it has been held that the "amounts that may be deducted as claims against the decedent's estate are such only as represent personal obligations of the decedent existing at the time of his death, whether or not then matured, and interest thereon which had accrued at the time of death."¹⁹⁶ Where guardian's fees or trustee's

190. Int. Rev. Code of 1954, § 2053(c)(2). (Emphasis added.)

191. For other examples, see Treas. Reg. § 20.2053-8 (1958).

192. S. Rep. No. 1622, 83d Cong., 2d Sess. 474 (1954).

193. Treas. Reg. § 20.2053-8(b) (1958).

194. See Rev. Rul. 61-59, 1961-1 Cum. Bull. 418, in which an attorney's fees for contesting the inclusion in the gross estate of certain items not subject to claims were deductible under § 2053(b) if paid within 60 days after the decision of the Tax Court became final.

195. Int. Rev. Code of 1954, § 2053(a).

196. Treas. Reg. § 20.2053-4 (1958).

termination commissions with respect to an included trust are concerned, the suggestion has at times been made that no personal liability exists. The courts either ignore this,¹⁹⁷ or pay lip service to it,¹⁹⁸ but, in any event, allow the estate to be reduced by the amount of the fees which relate to management of the property during the period prior to the decedent's death. This should include not only the fees or commissions, no matter when paid after death, but also the expenses incurred by the trustee in rendering a final account, such as attorney's fees and the like.¹⁹⁹ Such expenditures reduce the gross estate either as deductions or exclusions.²⁰⁰

This is not to say that local law does not play an important part in deciding whether or not the item is available. For example, the regulations suggest that, in order to be deductible, property taxes must not only be accrued in an accounting sense but also "must be an enforceable obligation of the decedent at the time of his death."²⁰¹ A thorough examination of the local law may be necessary to determine whether or not a real property tax, for example, is a deductible claim against the estate.²⁰²

3. Payment of the Tax

Payment of the tax, one of the last acts of an executor, can present unanticipated difficulties. The executor has no particular problem if the assets of the estate are readily saleable or have a current market. However, the executor with an extensive tract of land which cannot be sold except over a long period of time or with a quantity of the stock of a closely held corporation has troubles indeed. The Government will accept only cash for the payment of the estate tax, not land or stock of corporations, no matter how promising their futures may be. Fortunately, the Internal Revenue Code contains several provisions under which payment of the estate tax may be postponed.

Section 6161 of the Code allows the Secretary or his delegate, a district director, upon a showing of undue hardship, to extend the time for the payment of any part of the estate tax or the payment of any installment due under section 6166 for a reasonable period not in excess

197. Reynolds D. Brown, 20 B.T.A. 47 (1930).

198. Commissioner v. Davis, 132 F.2d 644 (1st Cir. 1943).

199. See Elroy N. Clark, 1 T.C. 663 (1943). The court held that the trustee's principal commissions with respect to individual and attorney's fees with respect to post death accounting should be allowed as deductions even though not paid until seven years after death.

200. Estate of Morton W. Reed, 8 CCH Tax Ct. Mem. 303 (1949).

201. Treas. Reg. § 20.2053-6(b) (1958).

202. See Magruder v. Supplee, 316 U.S. 394 (1942).

of ten years.²⁰³ The extension is entirely discretionary and does not mean that the return need not be filed.²⁰⁴ However, if granted, it also serves to extend the time within which state and foreign death taxes may be paid for purposes of the credit.²⁰⁵ The executor should note that state²⁰⁶ and foreign²⁰⁷ death taxes must generally be paid within four years after the return is filed.²⁰⁸ The payment of deficiencies may also be extended under this section. However, the extension is for only eighteen months, and in exceptional cases, twelve months more.²⁰⁹

The term, "undue hardship," generally has reference to a set of facts where the executor cannot convert the assets of the estate into cash except at forced sale prices and where he cannot borrow the money except on terms which are opprobrious.²¹⁰ If a market exists for the property, the district director will probably not find undue hardship even though the sale would be at a loss for income tax purposes. This loss would be due merely to general economic conditions.

It is not unusual for a decedent's estate to contain a reversionary or remainder interest created by the act of another. This the decedent's legatees will enjoy to the fullest extent only upon termination of a preceding estate, when their interest becomes possessory and they can receive and sell the underlying assets. Meanwhile, though, this remainder interest will be valued for inclusion in the decedent's gross estate, and money must be raised to pay the tax attributable to it. Obviously a sale of the underlying assets would destroy the interest of the preceding tenant, and the executor cannot usually sell or borrow upon the remainder interest itself. Section 6163 gives to the executor an election to postpone the estate tax attributable to the remainder interest until six months after the termination of the precedent interest.²¹¹ The estate tax attributable to the remainder interest is computed by multiplying the total tax times a fraction, the numerator of which is the reduced value of the remainder interest, and the denominator of which is the reduced value of the entire gross estate.²¹²

203. See notes 217-22 *infra* and accompanying text.

204. Treas. Reg. § 20.6161-1(c)(e) (1958), as amended, T.D. 6353, 1961-1 Cum. Bull. 697, 699. The application in writing must be made under penalties of perjury before the payment is due.

205. Int. Rev. Code of 1954, § 2011(c)(2).

206. Int. Rev. Code of 1954, § 2011(c).

207. Int. Rev. Code of 1954, § 2014(e).

208. For exceptions to this rule, see Int. Rev. Code of 1954, §§ 2011(c)(1)-(3), 2014(e)(1)-(2).

209. Int. Rev. Code of 1954, § 6161(b).

210. Treas. Reg. § 20.6161(b) (1958); Mim. 4303, XIV-1 Cum. Bull. 133 (1935).

211. Int. Rev. Code of 1954, § 6163.

212. Treas. Reg. § 20.6163-1(c) (1958).

The items of reduction are those claims, mortgages, losses, and charitable and marital transfers which serve to offset the numerator and denominator. Further, section 6163(b) allows the district directors, upon a showing of undue hardship, to postpone the payment for another two years.²¹³ One example of undue hardship would be the inability of the decedent's heirs to receive the assets comprising their remainder because of the time required to settle complex issues in the instrument creating the interest.²¹⁴

In the case of an extension under section 6161, the district director may require of the executor a bond for the payment of the taxes extended.²¹⁵ Apparently, however, a bond in the amount double the tax postponed is mandatory in the case of postponements attributable to remainder interests.²¹⁶

Several years ago the Small Business Tax Revision Act of 1958²¹⁷ added a new election, which is embodied in section 6166 of the Code, with respect to the payment of the estate tax. This provision is long and complicated, and no attempt will be made to explore it in full detail. Suffice to say that if the decedent had an interest in a closely-held business which exceeds either thirty-five per cent of his gross estate or fifty per cent of his taxable estate, the executor can elect to pay the tax in two or more, but not exceeding ten, equal installments.²¹⁸ The tax is found by multiplying the gross estate tax, reduced by state and foreign death tax credits, by a fraction, the numerator of which is the value of the closely-held business and the denominator of which is the value of the gross estate.²¹⁹ Deficiencies also can be paid in installments, but they cannot exceed the difference between the maximum amount of tax which the executor elected to pay in installments had the adjustments resulting in the deficiency been made at the time of election.²²⁰ The notice of election must be filed before the due date of the return and must contain all the facts upon which the executor bases his conclusion that the estate qualifies for this election.²²¹

213. Int. Rev. Code of 1954, § 6163(b).

214. Treas. Reg. § 20.6163-1(a) (1958), as amended, T.D. 6526, 1961-1 Cum. Bull. 402, 413.

215. Int. Rev. Code of 1954, § 6165.

216. Treas. Reg. § 20.6165-1(b) (1958).

217. Int. Rev. Code of 1954, §§ 165, 172, 179, 535, 1244, 1551, 6161, 6166, 6503, 6601, amended by 72 Stat. 676 (1958).

218. Int. Rev. Code of 1954, § 6166(a).

219. Treas. Reg. § 20.6166-1(b) (1960).

220. Treas. Reg. § 20.6166-1(d) (1960).

221. Treas. Reg. § 20.6166-1(e)(1)-(2) (1960).

It should be noted that none of the sections permitting postponement or payment of the estate tax absolves the estate from paying interest on the unpaid balance. Happily, however, the Code provides that if an extension is permitted under sections 6161(a)(2), 6166, or 6163, the interest with respect to the tax postponed is four per cent, rather than the usual six per cent.²²²

Finally, as noted before, where the estate includes stock of one (or in certain circumstances more than one) corporation having a value of more than either thirty-five per cent of the gross estate or fifty per cent of the taxable estate, said stock may be redeemed under section 303 without dividend consequences to provide for estate and inheritance taxes, funeral, and administration expenses. Although it is not necessary that the proceeds be actually used for the payment of these charges, the redemption must not exceed the sum of them.

4. Credits

The executor should keep in mind that certain credits are available against the federal estate tax. The most obvious is the credit for state death taxes.²²³ More easily overlooked are the credits for the gift tax paid with respect to certain included property,²²⁴ for postponed death taxes on a remainder interest,²²⁵ and for foreign death taxes.²²⁶ In connection with the last, consideration should be given to the treaty, if any, between the United States and the taxing jurisdiction. Finally, the executor should not overlook the possibility that the decedent may have received a bequest within ten years with respect to which a federal estate tax was payable. In such case a graduated credit is available for a ratable portion of the tax.²²⁷

IV. CONCLUSION

It cannot be the purpose of the above comments to provide any definite guide to an executor with respect to the income and estate tax consequences of any particular decision. Estates in form and character are as infinitely varied as the individuals from which they spring. Our purpose is rather to suggest that an executor give careful consideration to the income and estate tax results which may flow from each particular decision. We have mentioned many of the alternatives which are avail-

222. Int. Rev. Code of 1954, § 6601(b).

223. Int. Rev. Code of 1954, § 2011.

224. Int. Rev. Code of 1954, § 2012.

225. Int. Rev. Code of 1954, § 2015.

226. Int. Rev. Code of 1954, § 2014.

227. Int. Rev. Code of 1954, § 2013.

able to an executor during the course of his administration of an estate. We would hope, by calling attention to these, to prevent inadvertent decisions which, although defensible from the point of view of administration, may cause unintended tax hardships on the estate or beneficiaries. The above comments, however prolix, suggest that no election should be made without consideration of both the estate and income tax consequences thereof, the interaction of which is different in the case of each estate and each election. Finally, we hope that this article confirms the need for early and continued tax planning with respect to the administration of a decedent's estate, which planning can be of great benefit to the objects of the decedent's bounty.